Testimony of Richard F. Syron
Chairman and CEO, Freddie Mac
Committee on Financial Services
United States House of Representatives
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Chairman Frank, Ranking Member Bachus, members of the Committee:

My name is Dick Syron. I am the Chairman and Chief Executive Officer of Freddie Mac. I greatly appreciate the opportunity to appear before the Committee to discuss current developments in the subprime market. I will also discuss what can be done to alleviate the circumstances of some current subprime borrowers, and to help this market transition to a safer source of mortgage financing going forward.

Freddie Mac's Role

Freddie Mac participates in the subprime market by investing in highly rated AAA bonds backed by subprime mortgages. Given our role as a government-sponsored enterprise (GSE), we chose this financing strategy as a prudent way to provide liquidity to a largely untested segment of the mortgage market. These investments also have been a critical to our ability to meet our annual affordable housing goals.

Our participation in the subprime market has been as a responsible investor – and we continue to take that role very seriously. As announced two months ago, beginning in September 2007, Freddie Mac will restrict our subprime investments in securities backed by short-term adjustable-rate mortgages (ARMs) to those that have been underwritten to a fully-indexed, fully-amortizing level. We will also significantly restrict the use of stated income in lieu of more traditional documentation standards. As an additional consumer protection, we will encourage subprime lenders to escrow borrower funds for taxes and insurance.

We are also working on a major effort to develop more consumer-friendly subprime products that will provide stable financing alternatives going forward. These offerings will include 30-year and possibly 40-year fixed-rate mortgages and ARMs with reduced margins and longer fixed-rate periods. We plan to have our new offerings in the market by mid-summer.

These efforts follow in a long leadership tradition. Since 2000, Freddie Mac has taken unilateral, voluntary leadership positions that have helped improve subprime market practices. These include our bans on single-premium credit life insurance, prepayment penalties greater than three years, and mortgages with mandatory arbitration contracts, and our insistence on regular credit reporting. These requirements apply to all our mortgage purchase and investment activities. As I will describe later in this testimony, some initiatives have been followed by other market participants, others not. To the degree other market participants do not follow our lead, our ability to positively influence this market is limited.

In addition to helping set standards for sound mortgage lending, Freddie Mac also strives to help borrowers make good mortgage choices. Our Don't Borrow Trouble® consumer awareness campaign helps consumers avoid predatory lending practices, such as being charged excessive points and fees, or becoming a victim of deceitful lending practices.[1] Since 2000, we have conducted Don't Borrow Trouble campaigns in almost 50 cities and states throughout the country. These campaigns have helped inform more than 100,000 consumers across the U.S. about how to avoid predatory lending practices.

Another way we assist consumers is through our suite of multilingual credit education curriculum, CreditSmart®, CreditSmart® Espanol and CreditSmart® Asian. These programs are designed to give consumers information on establishing and maintaining good credit, the steps to homeownership, avoiding credit traps, and the benefits and responsibilities of owning a home. Freddie Mac believes that by educating consumers about smart credit habits and helping them understand the importance of obtaining and maintaining good credit, we can empower them with the skills and information necessary to achieving – and maintaining – homeownership. [2]

How We Got Here

To help understand the issue before the Committee today, it may be helpful to consider the underlying economics of what's been happening in the subprime segment of the mortgage market. Over the past decade, subprime has experienced a profound transformation in size, investor interest and mortgage type.

Using the tools of securitization and automated systems pioneered in the prime mortgage market, Wall Street and the global capital markets transformed subprime from a relatively small portfolio-based market that specialized in debt-consolidation refinances for credit impaired borrowers into a major market segment. [3] Representing about 15 percent of all single-family debt outstanding, today's subprime market provides home purchase mortgages as well as refinances to a much wider set of borrowers, including those with limited equity in their homes.

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[1] The City of Boston and the Massachusetts Community & Banking Council (MCBC) developed the original Don't Borrow Trouble campaign in 1999, which Freddie Mac later expanded nationwide. Boston's multi-faceted program reaches out to consumers through subway ads, television and radio commercials and direct mailings that direct consumers with questions to call the Boston Home Center. Consumers receive assistance depending on their problem, from homebuyer education to credit counseling to legal assistance if they are already in a predatory loan situation.

[2] See http://www.dontborrowtrouble.com/ and http://www.freddiemac.com/creditsmart/.

[3] The Federal Reserve has estimated that there was $10.2 trillion in single-family mortgage debt outstanding at the end of 2006 (*Flow of Funds Accounts of the United States*, March 8, 2007); typical estimates are that 15 percent of debt is subprime, or approximately $1.5 trillion.

In my view, three factors explain subprime's rapid growth and transformation: abundant liquidity flowing into the U.S. housing market from both domestic and international sources; a sustained period of low interest rates and relative prosperity, evidenced by sharply rising property values in many parts of the country; and an active desire on all our parts to expand homeownership to a broader segment of the U.S. population.

In response to the run-up in house-price inflation, many subprime borrowers sought mortgage products that lowered monthly payments, at least initially, to more affordable levels. Short-term hybrid ARMs, with lower initial rates, met this need. As long as house values continued to rise, equity was building up and the substantial transactions costs associated with refinancing to avoid the margin step-up could be absorbed.

On the supply side of the transaction, global liquidity drove investors to search for high-yielding instruments. One place they found more attractive risk returns was in the subprime market. To manage the higher risks inherent in these mortgages, structured subprime securities and derivatives were developed that diffuse these risks to an increasingly large and global investor base.

The confluence of strong borrower demand for low-payment mortgages and nearly insatiable investor appetite for yield fueled the origination of subprime mortgages, particularly 2/28 and 3/27 hybrid ARMs. Until recently, this set of economic factors had mutually beneficial effects. In a world of low mortgage interest rates and rising home prices, many homeowners using these products fared well.

Over time, however, intense competition in the lending market led to a relaxation of underwriting standards, such as the increased use of allowing borrowers to simply state their income on the mortgage application rather than following more traditional practices of verifying income and employment. There also were higher incidences of fraudulently inflated appraisals.

Today, the combination of rising short-term interest rates, softening house prices and lax underwriting has made these mortgages much more onerous for many borrowers. In what we believe to be the fastest downturn in housing markets in a long time, subprime loans originated in 2006 are performing far worse than prior years' originations. [4]

What's To Be Done?

Talk of market dynamics does little to allay concerns about the effects of rising foreclosures on borrowers and communities. Freddie Mac shares the Committee's deep

[4] "Early Defaults Rise in Mortgage Securitizations," Moody's Investors Service Structured Finance Special Report, January 18, 2007; and LoanPerformance, a subsidiary of First American Real Estate Solutions, TrueStandings Securities.

concern that many subprime borrowers may find themselves unable to refinance out of mortgage products that have become extremely burdensome in the current environment. We are particularly concerned that low- and moderate-income and minority families may be disproportionately hurt by the rising levels of subprime foreclosures, and that some communities with high concentrations of these mortgages will be seriously affected. We estimate that these borrowers account for roughly one-half of all subprime borrowers. In our view, these borrowers should be the focus of efforts to mitigate the effects of rising foreclosures.

To address the needs of this market going forward, Freddie Mac is working diligently with our customers to develop new products that provide more stable subprime financing. In addition to offering traditional long-term fixed-rate loans, we expect to offer ARMs of five years or more with margins at adjustment that are as much as 200 basis points below the current step-up.

To meet more immediate needs, we are considering modifications to our existing Home Possible® mortgage offering. Home Possible was designed to support our affordable housing goal requirements by targeting low- and moderate-income borrowers. It allows very high loan-to-value ratio loans to borrowers with less than stellar credit and who may be more highly financially extended relative to their income. These characteristics overlap with those in the subprime market, providing viable upstreaming opportunities for some segment of subprime borrowers.[5]

Forbearance, including loan modification of an existing mortgage, is another option. However, forbearance will be particularly challenging in subprime because of the increased use of structured securities. The terms of these securities are spelled out in legal contracts entered into by a multitude of investors worldwide. Under these agreements, servicers may choose to offer forbearance on a loan-by-loan basis in the case of default - or imminent default. However, forbearance and modification is a complicated process, and is only used to the extent that servicers believe forbearance will reduce the expected level of loss to the securities investors.

While these efforts will help cushion the expected rise in foreclosures, we need to be clear that these approaches will not provide the widespread panacea some are looking for. Many of the defaults we are seeing today are not the result of big adjustments at the two-year mark. Instead, many are occurring in the first few months after the loan was

[5] To be sure, prime products such as Freddie Mac's Home Possible represent limited solutions to the problems facing some subprime borrowers. Although Home Possible has been available in the market for a number of years, it has often not been the product of choice because it requires borrowers to provide documentation that allows an underwriter to verify the borrowers capacity to repay the mortgage. As a result, borrowers who may have misrepresented their income or assets may be unable to qualify for the tighter underwriting and documentation needed to refinance into more traditional mortgage products. In addition, it is important to realize that consumer-friendly products such as Home Possible have expected foreclosure rates that are significantly above those of standard prime loans.

originated – at the lower "teaser" interest rate. This suggests that many subprime borrowers have mortgages that should not have been made in the first place, at any price.

As we consider possible policy solutions, I would offer a few thoughts.

First, we would call on regulators and policymakers to agree on acceptable standards for disclosure, underwriting and performance that support sustainable homeownership for future subprime borrowers. While there is relatively little we can do about global capital flows and changes in interest rates, there is a place for measured regulation that protects borrowers from sharp downturns in housing and mortgage markets. Securitization may have made it possible to extend credit to virtually everyone at a price and "commoditize" mortgages like widgets, but the devastating effects of foreclosure on individuals and communities remain very real, personal and deep.

To prevent this type of situation from recurring, policymakers and regulators could play an important role in three key areas:

- Ensuring that all parties to the mortgage transactions have full and complete information. In this regard, the current focus on assuring adequate consumer disclosure is extremely important. For this to have benefit, however, new disclosures must be uniformly and consistently applied.

- Setting prudent limits on the socially acceptable level of defaults. A version of "Gresham's Law" clearly has been at work in subprime, that is, easy credit drives out prudent credit. To avoid the devastating effects of unacceptably high foreclosures, we need to set some limit on the level of risk we are willing, as a nation, to take in order to promote higher levels of homeownership.

- Ensuring a level playing field. As long as some institutions operate under different, or no, regulatory strictures, potential for these sorts of excesses and abuses will exist. As previously stated, Freddie Mac has a long history of voluntarily setting standards of prudent underwriting and of promoting greater borrower protections in subprime. However, we have to be realistic about our ability to influence lending practices in this market. Our share has declined significantly over the past four years as new investors who did not adopt our lending requirements entered the market. Relying solely on the GSEs will be ineffective because non-GSE investors account for the vast majority of subprime mortgages that have been securitized.

Second, we should carefully distinguish between those borrowers who can be "rescued" and those who cannot. I realize such a triage will not be easy or popular, but policy prescriptions such as widespread "bailouts" or foreclosure moratoriums should be considered only in certain extreme situations, such as in the aftermath of natural disasters. Broad application of such prescriptions could have lasting, unintended consequences that harm the housing finance system in the long term.

The entire housing finance system rests on the integrity and dependability of mortgage contracts between borrower and lender. Consumers need to have confidence that they understand the implications of the mortgages they take out and are able and willing to meet their obligations. Mortgage disclosures must be understandable. Having agreed to the mortgage terms, lenders must have confidence that they can enforce the terms. In the majority of instances, foreclosure is clearly an undesirable outcome for both parties, and there are strong incentives on both sides to "work things out." At the end of the day, the ability to enforce a mortgage contract, including the use of foreclosure, is critical to continued investor confidence in the U.S. housing market.

Third, we should resist the impulse to overcorrect this market. As stated earlier, many borrowers have benefited from the innovation available in subprime. Without the ability to get a subprime mortgage, many borrowers would not be homeowners today. Helping this market transition into a more stable source of financing is a desirable objective. Already there are signs a long-overdue market correction is underway; in 2007 the highest percentage of banks reported a tightening of mortgage standards since 1991.[6]

A broader point is that since resources are limited, it will be important to accurately dimension the size of the problem. There are many estimates of the projected level of subprime foreclosures – and even most conservative ones suggest a painful correction is underway, particularly in economically distressed areas.[7] Nevertheless, speaking as an economist, the data are "noisy." For example, the Colorado Division of Housing recently reported that the increase in foreclosures in that state is about one-third as much as had been reported by a prominent mortgage researcher.[8] Further, it is important to be aware that not every foreclosure filing results in an actual foreclosure. Our experience is that more than one-half of the loans that enter foreclosure are reinstated within a year.[9]

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[6] Federal Reserve Board *Senior Loan Officer Survey*, January 2007.

[7] A recent study by The Center for Responsible Lending (CRL) projects that 2.2 million subprime borrowers will lose their home to foreclosure. See "Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners," Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, CRL, December, 2006. On the other hand, a study by First American projects that 400,000 foreclosures will arise from subprime payment resets. "Mortgage Payment Reset: The Issue and the Impact," Christopher Cagan, First American CoreLogic, Inc., March 19, 2007, p. 69, Table 36.

[8] "In Brief: Colorado – Foreclosures Overstated by Some," *American Banker*, Marc Hostein, March 9, 2007. An analysis of Colorado public trustee data shows that state foreclosures rose 31 percent in 2006, compared to an 85 percent increase reported by RealtyTrac Inc.

[9] See "Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?" by Amy Crews Cutts and Richard K. Green. *Building Assets, Building Credit: Creating Wealth in Low-Income Communities*, Nicolas P. Retsinas and Eric S. Belsky, eds. 2005, Washington, DC: JCHS/Brookings Press, pp. 348-377.

Summary

A combination of economic and societal factors contributed to today's rising number of subprime foreclosures. These factors include low-cost mortgage money, rising house prices, including fraudulently set appraisals, pro-homeownership policies, lax underwriting, eager investors and willing consumers.

Addressing this complex situation will require multiple approaches, including self-correcting market mechanisms, targeted forbearance and innovative risk sharing arrangements, regulatory standards uniformly and broadly applied to all market participants, and the creation of new subprime mortgage products.

To be sure, as these corrective measures begin to take effect, there will be some unfortunate tradeoffs. These could include a possible reversal in homeownership gains and further softening of house prices, particularly in hard-hit communities. Regardless of the outcome, Freddie Mac remains committed to doing our part to help families while helping stabilize markets.

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Thank you again for the opportunity to appear before the Committee today. I look forward to your questions.